Subject: Managerial Economics

Semester/Year: II (Semester-II)

Name of the Teacher: Dr. Sudip Kumar Ghosh

Name of the Topic: Monopolistic competition

# Monopolistic Competition

The models of perfect competition and monopoly are useful, but there is a need to bridge the gap between these extreme forms of market structure. An important contribution is the model of monopolistic competition developed by Edward Chamberlin. Chamberlin observed that even in markets with a large number of sellers, the products of individual firms are rarely homogeneous.

## Characteristics

The theory of monopolistic competition has elements of both monopoly and perfect competition. Like perfect competition, it assumes that there are a

large number of small sellers. Thus, the actions of any single seller do not have a significant effect on other sellers in the market. Also, like perfect competition, it is assumed that there are many buyers and that resources can easily be transferred into and out of the industry. However, the model of monopolistic competition resembles the monopoly models in that products of individual firms are considered to be slightly differentiated. That is the product of one firm is assumed to be a close, but not perfect substitute for that of other firms. The result is that each firm faces a demand curve with a slight downward slope, implying that the individual firm has some control over price. Although increasing its price will cause

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the firm to lose sales, some consumers will be willing to buy at the higher price because the product is slightly differentiated from that of competitors. The characteristics of monopolistic competition are summarised in Table 1.

Table 1: Market Structure Characteristics of Monopolistic Competition

| | |
|---|---|
| Number and size distribution of sellers | Many small sellers. Actions of individual seller go unheeded by other firms |
| Number and size distribution of buyers | Many small buyers |
| Product differentiation | Slightly differentiated. Product of one firm is a fairly close substitute for that of other sellers |
| Conditions of entry and exit | Easy entry and exit |

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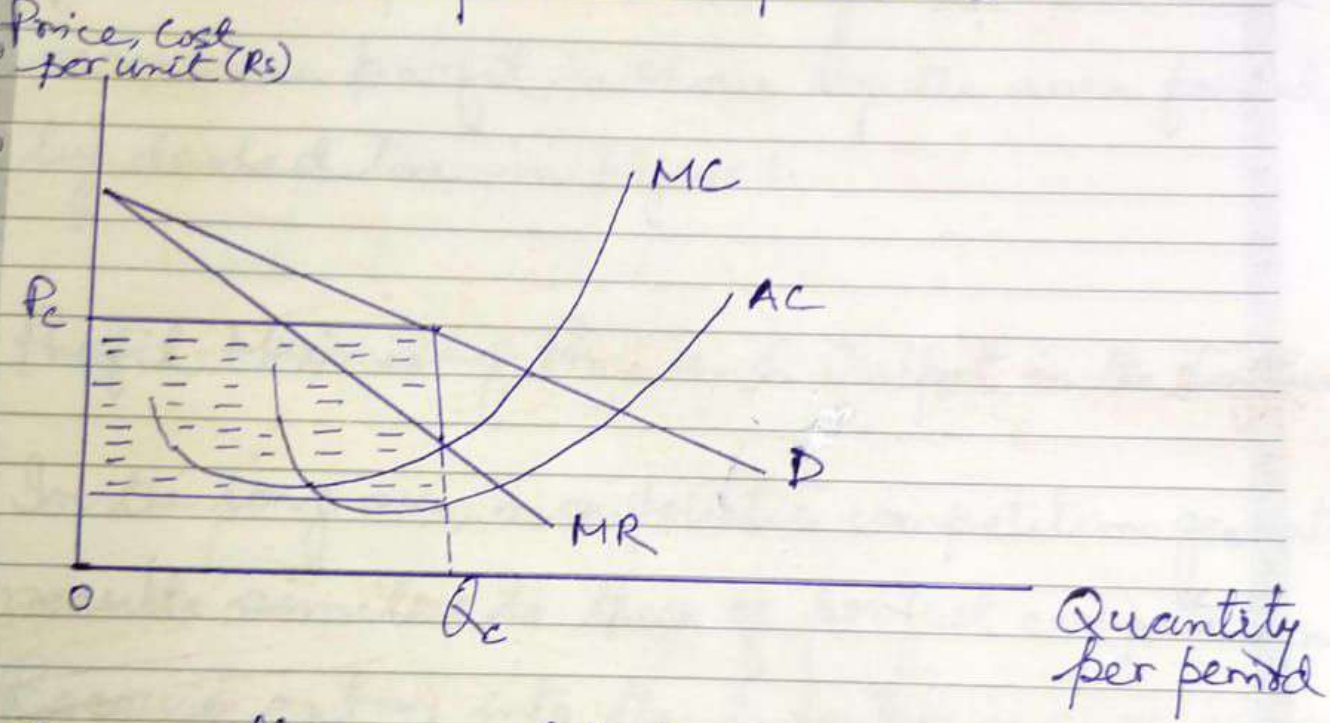
## Profit-Maximising Price and Output in the Short Run

Managers of firms in monopolistic competition determine the rate of output, product attributes, and advertising expenditure that maximises profits. To simplify the discussion, it is assumed that advertising and product attributes have already been determined. Therefore, determining the profit-maximising rate of output and price are the remaining decisions for managers. Chamberlin's monopolistic competition model also assumes that all firms have similar demand and cost curves. Thus it is possible to consider a 'representative' or 'typical' firm. The demand, marginal revenue, and cost curves for such a firm are shown in Figure 1.

Figure 1: Short-Run Profit Maximisation in Monopolistic Competition




The results of monopolistic competition in the short run are similar to those of monopoly. The profit-maximising output rate occurs at $Q_c$, where marginal revenue equals marginal cost. The corresponding price (as determined by the demand curve, D) is $P_c$. Like a monopolist, a firm in monopolistic competition may earn short-run

economic profit. Recall that economic profit per unit is price minus average cost. Thus, total economic profit is shown by the area formed by dashed line in Figure 1.

## Profit-Maximising Price and Output in the Long Run

In the long run, monopolistic competition generates results similar to those of perfect competition. Because entry into the industry is easy, economic profit induces other firms to enter the market. As a result, the market shares of existing firms decrease. Thus, the demand curve faced by these firms shifts down and to the left, until it becomes as shown in Figure 2.

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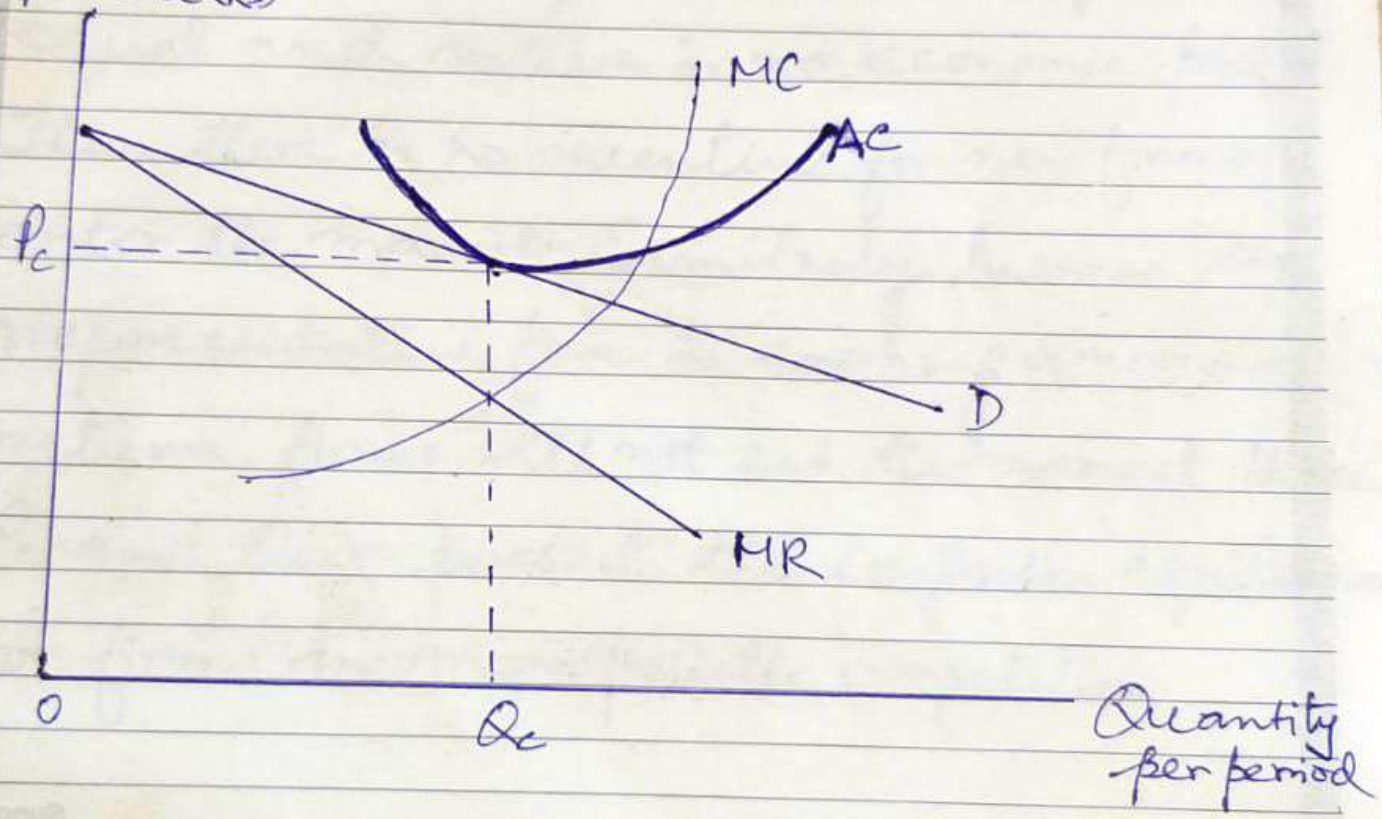
Figure 2: Long-Run Profit Maximisation in Monopolistic Competition




As in the short-run, the representative firm maximises profit by equating marginal revenue and marginal cost. In Figure 2, profit maximisation requires setting price at $P_c$ and producing $Q_c$ units of output per period.

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Note that, the demand and average cost curves are tangent at this price-quantity combination. This implies that price and average cost are equal and so there is no economic profit. Thus there is no incentive for new firms to enter the market. Similarly, because the representative firm is earning a normal return, firms will not exit the market. Hence Pc and Qc represent the long-run equilibrium for firms in monopolistic competition.

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